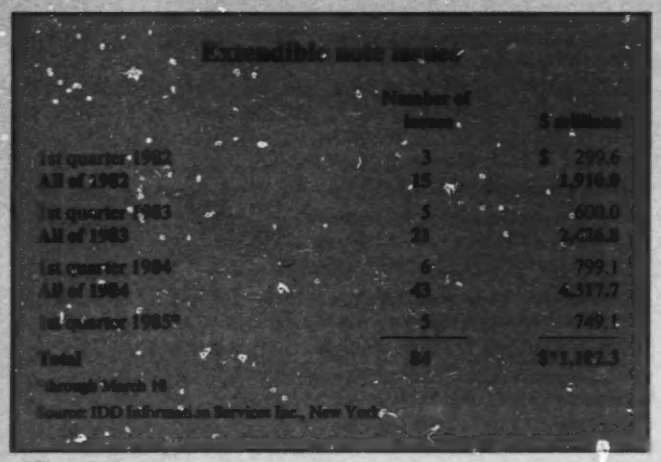
Corporate Finance



Extendible note issues

	Number of issues	$ millions
1st quarter 1982	3	$ 299.6
All of 1982	15	1,910.0
1st quarter 1983	5	600.0
All of 1983	21	2,636.8
1st quarter 1984	6	799.1
All of 1984	43	4,317.7
1st quarter 1985*	5	749.1
Total	84	$14,102.3

*through March 18

Source: IDD Information Services Inc., New York

Companies extend interest in notes

By Barry B. Burr

Since the first offering three years ago, extendible notes have increased rapidly in popularity — after a bit of refinement to keep investors from putting them back to issuers sooner than planned.

For example, Texaco Inc., White Plains, N.Y., is using extendibles as part of the refinancing of its takeover of Getty Oil Co., Los Angeles, acquired for $10.2 billion in February 1984, said Gordon Hamilton, Texaco's director of public relations.

In March, Texaco Capital Inc., the parent's financing unit, sold its latest issue of extendibles, raising $300 million.

Mr. Hamilton said Texaco Capital has sold a total of $1.3 billion in extendibles in three separate offerings, providing 30% of the $4.3 billion Getty refinancing of its floating bank debt done so far.

Extendibles basically provide longer term financing at shorter term rates, although particular terms vary with each issue. The notes, in general, have maturities of 15 years.

But issuers arbitrarily reset the coupon rates periodically, often every three years.

Buyers have the option at the time of the reset to accept the new rate or to put, or sell, the note back to the issuer at its face value. At the same time, issuers generally have the option at the time of the reset to call the notes.

Extendibles that are reset, say, every three years, offer rates similar to standard notes with similar maturities.

Extendibles, essentially, save issuers underwriting and other costs of issuing anew every few years with shorter term notes, according to issuers and underwriters. That cost amounts to about one-half or five-eighths of 1% of the face value of each issue.

For Borg-Warner Acceptance Corp., Chicago, its extendible issue didn't work exactly as planned.

Borg-Warner Acceptance, an autonomous subsidiary of Borg-Warner Corp. devoted almost entirely to providing financing for other companies, offered one of the first extendibles, in March 1982, selling $75 million maturing in 1992, with the coupon rate reset every two years.

Last year, when Borg-Warner

Continued on page 50

Biggest extendible underwriters

Biggest extendible underwriters

Lower-cost financing, a hedge

ECUs attract Hercules

By Marci Baker

WILMINGTON, Del. — Hercules Inc. achieved cheaper financing and a hedge for its foreign assets last month with the offering of notes denominated in European currency units.

The plastics and chemical company raised roughly $33 million through its 50 million-ECU deal in mid-March, making it the first American industrial firm and one of three issuers overall to offer such securities in the U.S. capital markets. The seven-year, 10⅛% notes were issued at par through underwriters led by First Boston Corp., New York.

ECU-denominated securities made their debut in the U.S. markets late last year when the European Economic Community issued 200 million ECUs, or about $145 million, of 12-year, 9⅛% notes.

Credit Foncier, a French thrift institution, is in the process of raising about $103 million in a 10-year, 150 million-ECU deal, through underwriters also led by First Boston.

Other U.S. issuers with sizable overseas operations are expected to follow Hercules into the ECU arena.

"This is ideal for multinationals," said Alexander Searl, Hercules' assistant treasurer. ECU-denominated securities provide a natural hedge to companies whose overseas operations expose them to international currency fluctuations, he said.

ECUs represent the currencies of the 10 European Economic Community members, including the deutsche mark, French franc, British pound and Italian lira.

Hercules, which derives more than 30% of its profits from overseas operations, has facilities based in all but two of the member countries — Ireland and Greece. However, the company's exposure to fluctuations in the value of the Irish pound and the drachma is minimal, Mr. Searl said. These two currencies make up only 2.5% of the ECU, he said.

The remaining 97.5% of the ECU offers long-term hedging opportunities for Hercules' European assets. By issuing the notes, Mr. Searl said Hercules is looking to maintain a balance between the value of its European-currency-denominated assets and the similarly denominated liabilities.

Thus, if the dollar strengthens, the decline in the value of foreign assets "will be offset with liabilities that melt just as fast," the assistant treasurer explained.

Other financing methods could have been used to hedge the company's European assets, but they would have been more cumbersome or costly, Mr. Searl said.

Each foreign subsidiary, for example, could have issued debt denominated in local currency. It was easier to do one larger offering under a single loan agreement than several smaller deals under separate loan agreements, he said.

Moreover, the interest costs in some cases would have been substantially higher.

Debt issued by Hercules' Italian subsidiary, for example, would have carried an interest rate that was several percentage points higher than the 10⅛% offered on the ECU issue.

"We picked up a very competitive interest rate by issuing the notes in the U.S.," Mr. Searl asserted.

Also, the interest cost on the ECU-denominated issue is about 220 to 230 basis points lower than what Hercules would pay out on a U.S.-based, dollar-denomin...

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Firms eye mortgage banking

By Marci Baker

Mortgage banking is gaining favor among industrial corporations looking to diversify into the financial services arena.

General Motors Corp., New York, moved quickly last month to establish its presence in the field. In the course of a week, its General Motors Acceptance Corp. unit had reached preliminary agreements to acquire the mortgage banking and servicing companies of Philadelphia-based CoreStates Financial Corp. as well as the mortgage servicing operations of Norwest Corp. in Minneapolis.

In addition, American Can Co., Greenwich, Conn., and Owens-Illinois Inc., Toledo, Ohio, recently acquired mortgage banking operations. Investment bankers expect more industrial companies will follow suit.

Indeed, other industrial companies with plans to move into financial services, such as Chrysler Corp., Detroit, cite mortgage banking as one viable avenue for expansion.

The growth business offers industrials the opportunity to bolster the growth of profits overall, said Bruce Cameron, vice president at Berkshire Capital Corp., a New York investment banking outfit. For many companies, mortgage banking also offers a logical extension of internal financial expertise.

For these reasons, industrial companies have been diversifying into financial services generally for the past several years. Deregulation in the financial services field and the emergence of a more service-oriented society have only intensified that trend.

"The basic underlying assumption for the industrial sector is that there will be lower growth for their businesses in the next decade. The financial sector is expected to grow more rapidly," said Harold Goldberg, chairman of the rating committee at Moody's Investors Service Inc.

With their basic businesses maturing, industrials have been forced to move into other growth-oriented industries.

The interest in mortgage banking, however, has come largely with the emergence of the mortgage-backed securities market, said Mr. Cameron. The banks generate substantial revenue from the sale of mortgages to the Government National Mortgage Association and other issuers of mortgage-backed securities.

Another attraction is the steady, but potentially lucrative income stream that a mortgage bank derives from the servicing of its mortgage portfolio.

The sizable profit potential was a

Continued on page 50

Notes

Convertible test OK'd

STAMFORD, Conn. — The Financial Accounting Standards Board has approved a new accounting test to determine when zero-coupon convertible and other convertible securities would be considered common stock equivalents for a company's earnings per share computation.

The retroactive ruling establishes an "effective yield" test that basically allows convertibles to be considered common stock equivalents, if at the time of issuance they have an effective yield that is less than two-thirds of the prevailing average double-A corporate bond yield.

Previously, the cash yield of convertibles had to meet this criterion.

While the new test paves the way for the advent of zero-coupon convertibles, issuers don't appear to be queuing up.

"We haven't seen any activity yet," said Wes Jones, head of corporate finance product development at First Boston Corp., New York. Although the yield test has been clarified, it will take some time to educate issuers on the idea of zero-coupon convertibles, he said.

First Boston, along with Merrill Lynch Capital Markets and Morgan Stanley & Co., both of New York, have been working on the idea of zero-coupon convertibles (*Pensions & Investment Age*, Jan. 7).

Merrill Lynch asked the FASB to address the accounting treatment of the security in a letter written last August.

Because zero-coupon convertibles would have no annual cash payments, they always would have been considered common stock equivalents under the old cash yield test, according to Ken Gerdesmeier, FASB project manager.

Mergers affect index

NEW YORK — The mergers and acquisitions activity is keeping Standard & Poor's Corp. busy making adjustments to its S&P 500 stock index these days.

Last year, the rating agency dropped 30 companies from the S&P 500 roster, replacing them with another 30 companies. Twenty-six of those changes stemmed from takeovers or leveraged buy-outs, said Elliott Shurgin, assistant manager-statistical research/index services.

In 1983, S&P had only 19 adds and drops, seven of which came from the breakup of AT&T.

Among the merger-related drops in 1984 were Gulf Oil Corp., which was bought by Chevron Corp., and Getty Oil Co., acquired by Texaco.

Extendibles . . .

Continued from page 49

Acceptance reset the coupon for the first time, investors put back for redemption about two-thirds of the notes, said O. Blaine Cox, treasurer.

Because of a general decline in interest rates, it reset the rate to 11.2% from the initial 15.65%.

But in between the several weeks the rate was reset and investors decided whether to hang on to the notes, interest rates rose sharply.

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Under the terms of the extendible, Mr. Cox said, Borg-Warner Acceptance was unable to readjust the new rate for the changing market conditions. Thus stuck with an uncompetitive rate, most noteholders put back their extendibles, he said.

"We had no way to overcome" the sudden change in market rates," Mr. Cox said. "We were locked in."

Associates Corp. of North America, Dallas, had a similar experience, with about 60% of its issue being put back, investment bankers said. Associates officials were unavailable for comment.

More recent extendible issues have refined the reset, Mr. Cox said, tightening up the time between the announcement of the new rate and the option of holders to put their notes.

Extendibles first came to the market March 9, 1982, when IBM Credit Corp. sold $125 million. Salomon Brothers Inc. was the lead underwriter.

The issue was followed closely by a $100 million extendible by Xerox Credit Corp., also handled by Salomon, and then the Borg-Warner Acceptance sale, managed by Goldman, Sachs & Co.

In that first year, $1.9 billion in extendibles were issued. The extendible market has more than doubled since then.

In all, $11.1 billion in extendibles has been sold in 84 different issues, as of March 18 (see *charts, page 49*), according to IDD Information Services Inc., New York.

Citicorp has been the largest issuer, selling 10 issues totaling $1.9 billion. At least two of its offerings were in Europe. Citicorp officials weren't available for comment.

The second largest issuer has been Texaco Capital, followed by Ford Motor Credit Co., Bank of America and IBM Credit.

Among other issuers have been Caterpillar Tractor Co. and Aluminum Co. of America, each with $150 million and underwritten, respectively, by Goldman, Sachs and First Boston Corp.

Five underwriters account for almost all the extendibles sold — 72 issues, totaling $10.4 billion.

Salomon, the largest lead underwriter, has handled 28 issues totaling $3.7 billion. Goldman, Sachs follows closely, with 21 issues totaling $3.1 billion.

The next three underwriters, grouped together in a pack further back, are Merrill Lynch Capital Markets Inc., First Boston and Shearson Lehman Brothers Inc.

Extendibles were conceived as a sort of bridge financing between issuing straight shorter term notes and longer term notes at a time when interest rates were falling, investment bankers say.

Issuers were reluctant to sell long-term debt when rates might fall further. Still, they wanted to avoid the expense of reissuing shorter term notes every few years.

Ryder Systems Inc. issued $75 million in 12-year 11.5% extendibles last November. It was Ryder's third public debt issue during the year. The others, totaling $175 million, were 10-year straight notes.

"We weren't particularly interested in them until the November time frame," said Charles F. Wilson, treasurer. The main reason was the unavoidable puts Borg-Warner Acceptance and other early issuers encountered.

But since then, Mr. Wilson noted, the refinements in the repricing make it more timely to a rapidly changing market.

"Before, there was no opportunity for you to increase your (coupon) price if the market went against you," he said. ■

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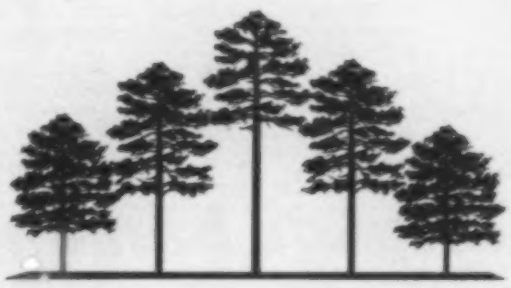

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Mortgage . . .

Continued from page 49

key reason for GM's decision to move into mortgage banking. CoreStates Colonial group, with a $7.4 billion mortgage portfolio, made $5 million last year, according to a GM spokesman. CoreStates Colonial is the mortgage banking unit of CoreStates Financial. Norwest's mortgage banking business lost $26 million in 1984.

In the Norwest deal, however, GMAC will acquire only the rights to service Norwest's $11 billion mortgage portfolio, which is less risky than the loan origination and packaging end of the business, investment bankers said. Under the agreement, GMAC also has the right to acquire Norwest's 52 loan-production offices and to originate mortgage loans at a later date. Terms of the two deals weren't disclosed.

The proposed acquisitions represent the first major steps in GM's previously disclosed diversification plans.

Once completed, the purchases will make the company the second largest mortgage banker in the country, based on the size of the two mortgage servicing portfolios.

The mortgage banking business "plays to the strengths of GMAC," the spokesman said. "It's a natural extension of what we do best." The GM unit provides auto-loan financing and servicing for consumers through more than 10,000 GM car dealers.

Owens-Illinois' move into mortgage banking with the acquisition of Alliance Mortgage Co. in Jacksonville, Fla., builds on the financial expertise it developed through its captive insurance and finance units and the internal management of pension fund assets. It also draws on the packaging manufacturer's back-office skills.

"The servicing end of the mortgage banking business is essentially a back-office one," said David Halmrast, vice president and general manager of financial services. "We are very good at systems, data processing and at maintaining cost control."

Owens-Illinois purchased Alliance from Florida National Banks for a total cash price of $125 million earlier this year. The deal was financed internally, mostly through its revolving credit line with a number of banks led by Bank of America, San Francisco. At year end, those credit agreements totaled $500 million. Berkshire Capital and Lazard Freres & Co. acted as financial advisers on the deal.

Slower growth in its traditional packaging business prompted the company to target financial services as well as health care as avenues of diversification, Mr. Halmrast said. Through acquisitions in these fields, the company is looking to boost its return on equity from its recent 10% to 11% range to between 15% and 20% annually.

The company chose mortgage banking for its first step into financial services because it promised relatively easy entry and the opportunity to become an industry leader, he said. For these reasons, Owens eschewed heavy retail oriented acquisitions.

"We wanted to avoid businesses that would put us in competition with giants like American Express," Mr. Halmrast said. Mortgage banking, on the other hand, is a fragmented industry in which no one company has more than 5% of the market, he noted.

Owens struck the deal for Alliance after looking at about 10 possible acquisitions. The largest mortgage banker in Florida, Alliance originates loans and services a $5.2 billion portfolio of residential and commercial mortgages.

Owens could be in the market for another financial services acquisition before year end. However, Mr. Halmrast said the company won't be ready to scout out any sizable deals for three to six months.

Although the GM and Owens acquisitions represent first steps toward financial services diversification, American Can's $125 million cash purchase of Berg Enterprises in Iselin, N.J., builds on an already established financial services unit.

The deal, expected to be completed in the second quarter, is part of an overall restructuring begun in 1982. At that time, American Can sold its manufacturing operations. It also targeted financial services, packaging and retail companies as areas of expansion. The company has focused its acquisition efforts on entrepreneurial companies with marketing or geographic niches, a spokesman said.

American Can bought four insurance companies, including Penncorp Financial Inc. and Transport Life Insurance Co. between April 1982 and October 1983. It also has moved into mutual fund and money management.

Along with the Berg deal, the company is acquiring Financial Institutional Services Inc., a firm that offers enhancement programs to help banks retain depositors.

Still, the mortgage banker and real estate syndicator "broadens what has been up until now an insurance-based unit," said the spokesman.

"We see a good fit in mortgage banking with our existing insurance operations."

Berg services a $1.6 billion mortgage portfolio and originates more than $1 billion of primarily single-family mortgage loans annually.

Since American Can launched its restructuring, the company's earnings per share have been climbing toward their 1979 peak of $6.50. Earnings per share as of June 30 were $4.95.

Financial services have been an important contributor to that progress. In 1984, 25% of the company's revenue and half of its profits came from this unit, the spokesman said.

Although mortgage banking promises many rewards, it has its risks as well. Chief among them is a company's exposure to interest-rate fluctuations.

Several months can elapse between the time mortgage loans are originated and then sold to mortgage-backed pools. "If a mortgage bank lacks a good hedging expert to protect against changing interest rates during that time, it can lose a lot of money," said Mr. Cameron. "But properly orchestrated, mortgage banking doesn't have to be among the high-risk financial businesses." ■

The Securities Data Corp. chart of new issues of corporate securities that normally runs in the Corporate Finance section was not received in time for publication. The chart for March 4-18 will appear in the April 15 issue.

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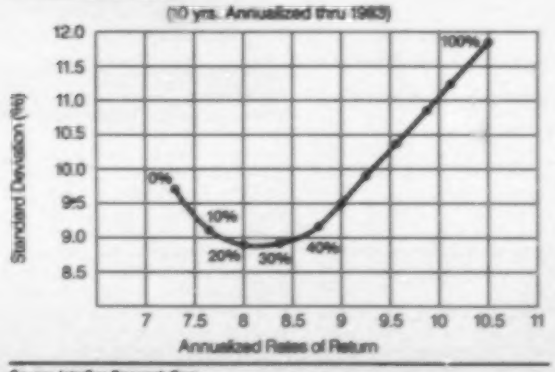

Source: InterSec Research Corp.

2 public funds . . .

Continued from page 2

No choice has yet been made for a permanent chief investment officer for the system, but a choice could be made later this month.

Funding for the new Detroit Retirement System managers came from terminating Alliance Capital Management, New York, which ran $90 million, from reducing the amount overseen by Comerica Bank-Detroit to $75 million from $285 million and from cash holdings. Comerica now will handle an equity portfolio, rather than a balanced one. The bank continues as master custodian.

In a related move, the Detroit public fund is allowing managers to increase their equity exposure to 50% from 35%.

Said Fred Murphy, executive secretary for the fund, "The state used to have a law that said the fund could only have 25% of the assets in equity. About 2½ years ago it was raised to a 60% limit, but initially the fund imposed an overall equity limit on the managers of 35%. Currently, the board doesn't want the manager's equity portion to go over 50%."

The board of trustees hired Prudential-Bache Securities Investment Management Consulting Services to aid in the manager search.

Mr. Murphy and Prudential-Bache's Harold Rossen, senior vice president, in a joint telephone interview, described the hiring.

"Last September, the fund decided to broaden its manager lineup," Mr. Murphy explained. "In looking over its three balanced managers — Scudder, Stevens & Clark, New York, Alliance, and Comerica — the board of trustees decided (Alliance's style) didn't complement the other managers.

"Also, the board was uncomfortable with the large amount, $300 million, overseen by Comerica. It decided that it didn't want any one manager to have more than $100 million."

From its 350-manager universe, Pru-Bache found the 87 firms it believed could handle amounts of at least $30 million to $40 million, Mr. Rossen said.

In addition, the fund wanted to look at 10 of the investment managers that had approached it.

"After reviewing performance and setting certain criteria — such as looking for those managers which had experience handling public money — we narrowed the 97 managers down to 20," Mr. Rossen said.

In early December, the fund interviewed the 12 firms and decided to visit seven of them, he said.

After the interviews, fund officials decided on a balanced lineup, except for Comerica. ■

Index funds . . .

Continued from page 1

grew to $14 billion at the end of 1984 from $11 billion at the end of 1983. By the end of February this year, the total went to $19 billion, Mr. Middleton said.

Wells Fargo is one of few firms offering index funds for bonds as well as stocks, but most of its business is in stocks, he said.

Another large provider of both bond and stock indexes is Bankers Trust Co., New York. Its indexed assets are more than $13 billion, up from $12 billion a year ago.

"Index funds are a conservative and relatively inexpensive vehicle to provide returns," said Patty Mahoney, assistant vice president.

Public pension funds' move into indexing is another factor in the growth of indexed assets, said Tom Loeb, president of Mellon Capital Management Corp., San Francisco. In 1984, Mellon's indexed assets rose to $4.4 billion from $500 million.

Mr. Loeb and Steve Manus, a vice president of American National Bank and Trust Co. of Chicago, agreed growth of pension funds has attracted sponsors to indexing.

"It becomes tougher to beat the market with all the money that's out there," Mr. Manus said.

American National manages about $5 billion in stock index funds, 10% more than last year.

Managers said pension funds of all sizes are using indexing. "I think an index fund has a place in any sponsor's portfolio," said Stephen Hawkins, vice president and senior trust officer at Manufacturers National Bank of Detroit. The bank's indexed assets rose $200 million to $1.6 billion last year.

Several managers said that although they market index funds, they still have faith in active management.

Most pension funds use indexing as a core investment strategy, then add active managers in hopes of adding value.

But at least one large active manager, Alliance Capital Management Corp., New York, added indexing late in 1984.

Alliance already has won $300 million in index fund business, said Carol Zipkin, vice president. Alliance offers customized index funds; a couple of clients have invested in indexes that avoid stocks in companies doing business in South Africa, she said.

Another new entrant in the index fund business is Great American Core Investors, Tarrytown, N.Y.

Its president, Seth Lynn, and chief operating officer, Robert Windsor, left Bankers Trust to set up the business last year.

Handling index funds only, they have $85 million under management, all from the San Francisco City and County Employees Retirement System.

"In the public funds arena, the core fund is a very appealing concept for political reasons," Mr. Lynn said.

Public fund executives, under scrutiny from press and politicians, don't get much credit when investment performance is good, he said. "But if they make mistakes, they're going to get tarred and feathered," he said. Index funds, he said, can help prevent the latter.

Specialized indexes appear to be attractive to pension funds. State Street Bank & Trust Co., Boston, saw its index funds grow largely because it offers unusual instruments, such as the stock index performance futures fund, said Tom Hogan, a vice president.

State Street has about $1.6 billion in index fund business, up from $1.3 billion a year ago, he said.

Throughout the industry, the variety of index fund products is wide. Many hold all or part of the S&P 500, while "extended market indexes" consist of thousands of stocks.

Some only hold growth stocks or stocks in small companies. Still others use timed indexing strategies, in which funds are moved between cash equivalents and index funds or index futures.

Index fund managers said they look for further growth. Passive funds will not always outperform an overwhelming majority of active managers, but will remain a sensible core strategy and an efficient way to diversify, Mr. Lynn said. ■

Revised FASB proposal

Major shift seen in accounting

By Marci Baker

STAMFORD, Conn. — The recently issued, long-awaited exposure draft on pension fund accounting still would result in a major change from past practices, even though it represents a modification of past proposals.

For some companies, the Financial Accounting Standards Board's new proposal — issued on a 5-2 vote — will mean reporting significantly larger pension expenses than they do now.

All companies will be forced to disclose more detailed information on how well their plans are funded and what assumptions are used to calculate that information.

The FASB hopes the result will produce pension accounting measures that are more consistent among companies and more understandable to users of pension fund data.

Among the key provisions of the draft, said Timothy Lucas, an FASB project manager, is a requirement to report unfunded liabilities on the balance sheet.

Until now, companies have reported assets and accumulated liabilities in the footnotes of financial statements.

Under the proposed changes, unfunded liabilities will be moved onto the balance sheet. However, those liabilities will be calculated on the present value of accumulated vested and non-vested benefits — a step back from the FASB's previous stance.

Originally, the board had considered requiring companies to include future salary increases in the liability calculation, which would have increased the liability that would have been reported as well as the number of companies subject to the rule.

The FASB draft also will require companies to compute pension expenses based on the benefit terms of their plans, typically some percentage of final pay times number of service years.

"A lot of times, funding has dictated what a plan's pension expense should be," said Doug Sauter, an FASB project manager.

Plan sponsors look to line up the funding level for the plan in a given year with their net periodic pension cost by working with a number of pension expense calculations.

The proposed method narrows the number of options in measuring expense and separates that function from the funding function, said Mr. Sauter.

The FASB believes the new method will be a more faithful representation of pension costs "because it reflects the terms of the underlying plan and because it better approximates the recognition of the cost of an employee's pension over that employee's service period," according to the exposure draft.

A company's pension expense generally is not expected to increase with the FASB's ruling on the matter. Jerry Spigal, an actuary with Peat, Marwick, Mitchell & Co., said it is one of the lowest cost methods of determining that cost.

What will increase pension costs for many companies, however, is the board's provisions on prior service costs. The FASB draft will require companies to tighten up the amortization period for recognizing increases in benefits that stem from plan amendments.

Now, companies will write off those costs during a 20- to 30-year period. Moreover, the benefit increases typically are applied on a flat-payment basis, which is similar to mortgages.

Under the exposure draft, prior service costs will be applied over the estimated years of employee service until retirement.

The FASB also will require companies to use a projected unit cost system for amortizing those costs, resulting in a shorter write-off period. Also, a greater amount of these costs will be applied at the front end of the amortization period and will dwindle over time.

In another key departure from current rules, companies will have to disclose in footnotes more information about their pension plans. Now, companies typically report pension assets available, accumulated vested and non-vested benefits, actuarial assumption used and dollar pension expense.

Among the additional information to be included is an assumption of the rate salaries will increase — a rate that must be compatible with what companies think pension plans will earn on investments. Companies also must include what impact a percentage point change in those assumptions will have on the projections.

Other additions include the effect future compensation levels will have on pension obligations and the amount of prior service costs not yet reflected in the net periodic pension costs.

Overall, how companies feel about the new rules "depends on where you sit in your funding status," said Larry Wiltse, consulting actuary at Buck Consultants in New York.

Companies with overfunded plans may find the draft a reasonable compromise, while it may prove more burdensome for those with unfunded liabilities.

Indeed, companies with unfunded liabilities, like Chrysler Corp., are not applauding the new proposal. Chrysler reported a $700 million unfunded liability at the end of 1984. If that situation continues into 1989, when the balance sheet rules would be effective, it will be faced with reporting a liability on its balance sheet.

"From our perspective, it's pretty much no change from past FASB proposals," said Marty Welch, Chrysler's assistant controller. "A huge penalty will be paid by companies with mature plans."

Most damaging to the automaker is the provision for amortizing prior service costs, Mr. Walsh said. Chrysler now takes 30 years to write off those costs in its union negotiated plan.

Under the new prior service rules, Mr. Walsh said, the company's amortization period could be cut in half.

Overall, experts agree the smokestack industry would be hardest hit by the proposed rule changes because they are more likely to carry unfunded liabilities and make more frequent changes in the level of benefits.

Still, they note, these companies represent the minority, as the vast majority of pension plans in recent years have become overfunded.

FASB's Mr. Lucas estimated that only 20% of major U.S. corporate pension plans currently may have unfunded liabilities.

The changes in pension accounting rules are expected to prompt even more companies to put more pension assets in passive bond portfolios, in an effort to reduce pension expense and smooth out the volatility of assets and liabilities.

The FASB will hold public hearings on it exposure draft July 22-24 in New York. It hopes to release the final version by year end.

GE fund . . .

Continued from page 1

pension plans are getting mature and payments to retirees are a big part of that pension plan."

"You're not just looking to get the best return (with pension investments)," he added. "But you have (cash for) liabilities to pay.

"It's the only sound way to go about asset allocation."

GE's dedication is the pension fund's first, said Mr. Bunch.

"This fixed-income portfolio, consisting of securities backed by the U.S. Treasury, has been dedicated to the payment of certain future pension benefits . . . (and yields a) rate of return of 13.4%," GE's 1984 annual report states.

Mr. Bunch said GE set up the dedication itself, although it worked with several unidentified brokerage houses in buying the bonds. GE, which manages nearly all its pension assets internally, is managing the dedicated portfolio itself as well, he added.

He said GE first began buying securities for the dedication in mid-1984 and completed the portfolio toward the end of the year.

Mr. Bunch, who confirmed the dedicated portfolio consists entirely of zero-coupon Treasuries, said details weren't available on the zeros.

The money for the dedication came from the fund's cash flow, said another GE official.

The move apparently is the fund's first major investment switch since Dale F. Frey, GE's former treasurer, replaced Edward H. Malone as trust investments vice president and head of the fund.

Mr. Bunch said that without the dedication, GE's 1984 contribution would have been $531 million, instead of the actual $502 million. Mr. Bunch said GE reports as a corporate expense the same amount as its pension contribution.

However, employee contributions to the pension trust, totaling $101 million, were unaffected by the dedication.

In 1983, the company and its employees contributed, respectively, $545 million and $87 million.

GE's report said, "If the dedication had not occurred, the present value of benefits at the end of 1984 would have been $580 million greater."

GE still reported an increase in liabilities apparently caused by other factors. Its liabilities at Dec. 31, using a 7.5% discount rate, were $9 billion, up from $8.5 billion a year earlier.

The report said the 13.4% dedication yield, however, influenced the cut in liabilities and contributions.

By dedicating, in general, a plan matches certain assets (the dedicated portfolio) to certain liabilities (some retiree payments). It buys bonds so cash inflows from coupon income and maturing principal matches as closely as possible the periodic outlays required to pay retirees. GE of course is using zeros, which have no coupons and thus carry no reinvestment risk. ■

C2710-2

Study prompts soft-dollar questions

NEW YORK — Leading block-trading houses on Wall Street execute even "easy" trades more efficiently than smaller brokerage houses, a new study shows.

The results of the study seem to throw into question the practice of some pension funds and money managers directing all or part of their trading to smaller brokerage concerns for lower commission costs and rebates or the provision of services paid for by the broker.

The Securities and Exchange Commission and the Department of Labor have been examining the use of soft dollars by money managers and their pension clients for the purchase of research and other services.

In a soft-dollar transaction, a pension fund or a money manager directs trading activity through a broker. The broker agrees to use part of the commission generated by the transaction to pay for a service needed by the pension fund or the money manager.

The study, if accepted by the SEC and the Labor Department, would make it difficult for pension funds and their money managers to justify soft-dollar payments through second-line brokerage firms, and for consultants and outside research firms to receive payments in soft dollars.

However, some traders have raised questions about the study's methodology.

The study — conducted by Gilbert L. Beebower, senior vice president of SEI Corp., for Donaldson, Lufkin & Jenrette Inc. and Goldman, Sachs & Co. — showed that even in easy trades, the market impact was substantially greater when carried out by smaller brokerage firms than when carried out by a large block-trading house.

The market-impact cost advan-

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Late news

Groo to leave firm

NEW YORK — Lawrence Groo, a partner and key portfolio manager at Forstmann-Leff Associates, will leave April 30 to launch his own investment management firm.

Mr. Groo has run both equity and balanced portfolios for the $4 billion money management operation.

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Pensions & Investment Age

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Value of Conrail ESOP shares unclear

By Joel Chernoff

WASHINGTON — While the federal government might reap $1.2 billion in cash from selling its 85% interest in Conrail to Norfolk Southern Corp., participants in Conrail's employee stock ownership plan might not get a nickel for their 15% of the company.

Giving the 79,700 participants nothing for their 15% interest might seem far-fetched, but one source insisted it is a serious option.

Regardless of whether the concept is just another salvo by opponents of Conrail's sale or a real possibility, there are serious fiduciary issues raised in the valuation of the ESOP stock and how the rights of participants are affected.

Even under the best possible scenario now being weighed, participants apparently would not receive the value of Conrail tax credits to be surrendered by Norfolk Southern in setting the value of their shares.

In addition, if the transaction proceeds as planned — which might be a lot to assume given obstacles in Congress — the participants never would have any say in the matter, either before or after the deal is consummated. In addition, some might not be represented in negotiations concerning the plan's value.

In a separate issue, several senators also have raised concerns that Norfolk Southern would terminate Conrail's pension plan for salaried employees, which has an estimated surplus of $250 million.

Given the attention being paid to antitrust and tax issues in the proposed deal, the issue of the Conrail ESOP virtually has been ignored.

"There is a significant question of what the old ESOP is worth," said Brian Freeman, financial adviser to the Railway Labor Executives Association, which represents organized rail labor.

"Certainly there is a fairly wide range and there are substantial issues as to what that value might be," commented an official at the Department of Transportation's Federal Railroad Administration, which is selling Conrail.

The official said the RLEA and Norfolk Southern are negotiating the terms of the valuation, which would be subject to a review by a special court. However, he declined to comment on specifics, for fear of upsetting the negotiations.

A spokesman for Norfolk Southern declined to discuss the valuation issues, but noted the firm is committed to spend $375 million to buy out the employees' interest, redeem previous wage concessions and ensure employee rights to buy future stock.

However, no breakdown of the $375 million total has been made, he said.

Philadelphia-based Conrail, which prefers taking the company public, declined to comment on the ESOP provisions.

Under 1978 legislation, Conrail was required to set up the ESOP in return for a $345 million federal investment. In 1980, the company contributed 4,411,760 shares of

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General Dynamics' plan

Treasuries a key

By Richard J. Gillespie

ST. LOUIS — General Dynamics Corp., a company that sells almost exclusively to the U.S. government, does a lot of business with Uncle Sam when it comes to investing — holding more than $1 billion in U.S. government securities.

Most recently, General Dynamics put 60% of its $1.8 billion pension fund into bonds, $350 million of it into Treasuries in an actively managed laddered portfolio.

(The company's $1 billion employee savings plan has $300 million in U.S. government securities, invested at the employees' discretion.)

"We have got an approach that we think is the right way to go, recognizing that we are a government contractor and we tend to be risk averse," said John P. Maguire, vice president and secretary.

"But whether anybody can write an article saying this is a solution to other people's problems, I think is wrong. We are just trying to evolve a solution to our particular problems."

"We started out on the premise that we cannot forecast interest rate trends and so we decided to set up a 10-year laddered portfolio with 10% of the funds maturing every year," said Charles D. Walbrandt, staff vice president for employee benefit trust funds.

"So whether the general level of interest rates is up or down, we will be on a middle course."

The solution General Dynamics pension fund managers found is unique in the trillion-dollar pension fund industry, according to Gifford Fong, president of Gifford Fong Associates, a bond management consultant.

Eschewing the perils and rewards of interest rate forecasting, the General Dynamics plan set up a $350 million core bond portfolio last fall, with the assets divided equally among each of 10 annual maturity categories of from one to 10 years.

Within each of the 10 maturity categories, the bonds are traded actively based on strict value parameters provided by a term

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Starting the new job June 1 "at a run instead of a crawl."

— Greta E. Marshall

California PERS selects Marshall

By Steve Hemmerick

SACRAMENTO, Calif. — Greta E. Marshall has been signed to a three-year contract as investment manager of the $25 billion California Public Employees' Retirement System.

Ms. Marshall, president of BayBanks Investment Management, Boston, said she will start her new job — a post that had been vacant for more than two years — June 1 "at a run instead of a crawl."

She will earn $125,000 a year base salary plus a bonus of up to $25,000 the first year of the contract, $50,000 the second year and $75,000 the third.

Some observers view her hiring as a sign that the nation's third largest pension fund will continue to run the bulk of its assets in-house. Ms. Marshall said she generally favors in-house management for large pension funds, and is "amazed" more of them don't manage their assets internally.

Before joining BayBanks 16 months ago, Ms. Marshall was manager of about $1.5 billion in pension assets for Deere & Co., Moline, Ill.

Support for in-house management also has come from Wilshire Associates, the fund's consultant, which just issued a report indicating at least 70% of assets should remain in-house. Wilshire has been doing an asset allocation study for the fund.

The study also calls for some spe-

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When is a zero not a zero?

By Barry B. Burr

News analysis

Wertheim & Co.'s filing with the Department of Labor seeking permission to contribute a "zero-coupon note" to its own pension plan has raised a number of questions about the investment.

- Is a 35-year note that has semi-annual payments over 20 years a zero-coupon security? Wertheim said it is.
- Does it lock in a yield? Moore Juran & Co., engaged by Wertheim as an independent fiduciary and appraiser, also calls the note a zero-coupon security and claims it locks in a return, avoiding reinvestment risk.
- How involved are pension investment committee members with the investments? At least three of the five members of Wertheim's pension investment committee said they were unfamiliar with the proposed transaction.
- Is a fiduciary a fiduciary if it doesn't know it is one? At Moore Juran, Michael G. Dunn, senior vice president, said, "I don't know what an independent fiduciary is."
- How closely does the Department of Labor examine exemption proposals? Two DOL officials didn't question the use of the description of the note as a zero or as locking in a return.

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2 new venture capital deals attract pension fund assets

By Steve Hemmerick

Several pension funds have committed assets to two different venture capital funds at a time when investment in that area is seen by some as more cautious than in the past.

The Federal Express Corp., Burroughs Corp. and General Electric Co. pension funds committed, with many other limited partners, $178 million to a new venture capital fund formed by Welsh, Carson, Anderson & Stowe.

Sources said other participants included Minnesota Mining & Manufacturing Corp. and Prudential Insurance Co. of America; neither used pension fund money.

Several other unidentified pension funds, insurance companies and endowments committed assets, but Pat Welsh, a general partner with the New York-based venture capital group, declined to name any of the investors.

On the other side of the country, Crosspoint Venture Partners, Mountain View, Calif., attracted $42 million from the Sears, Roebuck & Co. pension plan and General Electric Venture Capital Corp., among others, to its second fund.

Other pension and tax-exempt money to the Crosspoint fund came from investment advisers, such as First Chicago Investment Advisors, Chicago; Investment Advisers Inc., Minneapolis; and Wolfensohn Associates, New York.

A Sears spokesman would not comment on the pension fund's investment. Sears was estimated to have committed about $1 million, as was Wolfensohn Associates, while First Chicago was estimated to have committed $2 million. Estimates from other firms were unavailable.

Other investors in the fund included Acacia Life Insurance Co., Washington, and four unidentified venture capital firms.

Welsh, Carson, Anderson & Stowe makes the majority of its investments in the East Coast in information processing and health care start-up companies; this is its fourth fund.

It also has participated in 11 leveraged buy-outs, primarily of midsized information processing firms being divested by larger companies.

While venture capital contributions might be declining, Jeffery O. Drinan, senior manager-trust investments for Federal Express, Memphis, Tenn., said it is difficult to time venture capital markets.

Mr. Drinan said that if someone were trying to time the market — and he stressed he is not — he believes now might be a good time to do so because venture capital deals aren't overpriced as they were 18 months ago or so.

The commitment to Welsh, Carson's fourth fund was the first venture capital move for the $85 million pension fund at Federal Express, a company considered a major venture capital investment success itself in the early 1970s. The amount was undisclosed.

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Cash holdings still dropping

By Fred Williams

Money managers continued to draw down cash reserves in their equity portfolios during the first quarter of 1985, and guessed correctly by investing in some of the best-performing market sectors.

According to statistics compiled by INDATA, a Connecticut-based investment analysis firm, cash reserves dropped to 6.3% at the end of March from 7.6% at year end 1984, the low for that year.

At one point during the quarter, cash reserves reached 5.8%, nearing the all-time low of 5.4% hit in September 1976, INDATA statistics show.

The INDATA research, which covers 1,063 portfolios with a value of approximately $103.6 billion, also found more money managers — but still a minority — outperforming the benchmark Standard & Poor's 500 stock index.

For the quarter, 45% of investment managers outperformed the S&P; for the 12-month period ended March 31, about 41% of managers beat the market. Only 30% outperformed the market in 1984.

One reason for the improved performance by investment managers might be that they were overweighted in some of the better performing stock sectors for the quarter, even though they were underweighted in the best-performing sector — energy. The S&P index was up 9.2% for the first quarter.

According to INDATA, portfolio managers held an average of 10.4% in financial institutions, while the S&P had a 6.6% weighting in financial stocks. Financials were up 11.9% for the quarter.

Another sector in which money managers were overweighted was consumer cyclical stocks; they made up 17.6% of institutional portfolios and only 15.8% of the S&P. The consumer

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EDS asks exemption for purchase

By Fred Williams

DALLAS — Electronic Data Systems Corp. is asking government approval of a 1984 transaction in which General Motors Corp. used its common stock and notes to purchase EDS stock from two employee benefit plans as part of the merger between EDS and GM.

Trustees of the two EDS plans are seeking an exemption from the Employee Retirement Income and Security Act's prohibited transaction between a plan and a party in interest.

GM and EDS agreed in August 1984 to a merger plan in which the automaker would acquire EDS for $2.6 billion.

As part of the merger agreement, GM formed a wholly owned subsidiary to acquire 100% of the outstanding EDS stock. GM entered into a separate agreement with top EDS officers, including H. Ross Perot, founder and chairman of the board, to purchase their EDS shares, which amounted to about 29 million shares, or about 49% of the outstanding EDS stock.

That agreement came just before the merger. The rest of EDS' shareholders were given two stock purchase agreement choices.

Shareholders were given the option of accepting a flat $44 for each EDS share or $35.20 in cash per share and fractional shares of a new class of GM common stock and fractional interest in GM notes issued in connection with the merger.

EDS' $54 million defined benefit pension plan held about 142,000 shares valued at about $4.4 million, and the $5.8 million EDS 401(k) plan held about 52,277 shares valued at about $1.6 million.

Prior to the effective date of the merger, EDS plan trustees hired MBank, Dallas, as an independent fiduciary, giving the bank the authority to dispose or retain EDS stock held by the two benefit plans. The bank also was empowered to make decisions relative to voting for or against the merger and to choose which option to receive in payment for shares held in the plans.

Bank officials determined it was in the best interest of plan participants to vote for the merger. Bank officials selected the payment option involving GM cash, stock and notes.

A Department of Labor spokesman said that had the stock purchase been conducted strictly on a cash basis, an exemption from ERISA regulations would have been unnecessary and the transaction would have been covered "by statutory exemptions."

"But since they paid in cash, notes and shares, and after the sale GM became the plan sponsor, in effect it looks like it involves the extension of credit from the sponsor to the plan. A note involves a continuing liability and shares of stock, which may be all right, but an exemption covers that too," he said.

"They made sure an independent fiduciary evaluated the options and made sure the consideration given to plan participants was not less than anyone else got."

Participants in the 401(k) plan were offered the opportunity to vote on the merger by proxy before MBank became independent fiduciary. Participants holding 36,371 shares voted in favor of the merger and 2,115 shares voted against, while 421 shares were directed to abstain.

Neither GM nor EDS officials commented by press time. ■

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Late news

Simmons ruling

PEORIA, Ill. — Takeover specialist Harold Simmons breached ERISA regulations by using pension assets to help buy a company, a federal judge has ruled.

Mr. Simmons, a director of Keystone Consolidated Industries Inc. here, used $15 million from the Keystone Master Pension Trust to acquire stock in Amalgamated Sugar Co., Ogden, Utah, in 1982. Six pension plan participants sued in 1983, charging him with misuse of plan assets.

District Judge Michael M. Mihm ruled Mr. Simmons and his co-defendants violated the Employee Retirement Income Security Act by failing to act for the exclusive benefit of pension plan participants and beneficiaries, failing to act prudently and making prohibited transactions. The ruling will not be final until he issues a memorandum opinion, sometime after April 24.

Continental cuts 5

STAMFORD, Conn. — Continental Group Inc., with roughly $1.1 billion in its pension and employee benefit funds, has terminated at least five of its outside money managers, according to sources.

The move apparently is the result of the company being acquired by the Kiewit/Murdock Investment Corp. last year.

Equity accounts with Lord Abbett & Co., Jennison Associates Capital Corp., and Vilas Fischer Inc., all in New York, were liquidated, along with international equity accounts with Morgan Grenfell Investment Services Ltd., in London, and Rowe Price-Fleming International Inc., in Baltimore. The amounts were not revealed.

Exemption expanded

WASHINGTON — The Department of Labor has expanded a class exemption from prohibited transaction rules allowing pension plans to purchase certain money market instruments from parties in interest to the plan.

In 1981, the department allowed plans to invest, under certain conditions, in bankers' acceptances, commercial paper and certificates of deposit issued or held by parties in interest.

Now, plans also can enter into repurchase agreements with dealers of bankers' acceptances that report daily to the Federal Reserve System. In addition, plans can buy any security issued by a commercial bank or its affiliate where the bank is a party in interest solely because of providing checking sources to the plan.

IRS issues proposal

WASHINGTON — The Internal Revenue Service has proposed rules governing tax treatment of deferred compensation plans for foreign branches or subsidiaries of U.S. firms.

The proposal, issued after a 4½-year wait, is particularly tough on foreign book reserve plans, which require liabilities to be booked but paid only when due, according to Kwasha Lipton, a Fort Lee, N.J.-based benefits consultant.

Reserve plans must use the unit credit method in actuarial calculations and cannot include expected salary increases. In addition, effects of plan amendments, experience gains and losses and other changes must be amortized over 10 years.

N. Ireland plan OK'd

NEW YORK — The trustees of the more than $8 billion New York City Employees Retirement System unanimously approved a resolution to help fight discrimination in Northern Ireland.

The resolution, which calls on corporations to sign the MacBride Principles, relies on proxy resolutions to ensure compliance.

Personnel moves

• PASADENA, Calif. — William J. Chadwick and Nori Gerardo are resigning from the Los Angeles-based law firm Paul, Hastings, Janofsky & Walker to join Public Storage Inc. May 1 to market the firm's mini-warehouse properties to institutional investors.

• NEW YORK — Kevin Sullivan, vice president of the executive search firm of Handy Associates, has left to become a partner at Warren Management Consultants, a financial services recruiting firm.

• DEARBORN, Mich. — Kenneth C. Merrill has been named to replace Robert C. White as head of investments for the $12.5 billion Ford Motor Co. retirement plans. Mr. White retired April 1.

• WASHINGTON — Mark O. Decker has been named executive vice president of both the Pension Real Estate Association and the National Association of Real Investment Trusts. He replaces Mercer L. Jackson, who resigned.